Guidance for the Third Analyst in a Three-Analyst Valuation Process

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Both shareholder contracts and shareholder controversies often call for three valuation analysts to participate in the ownership transition valuation of the subject business, business ownership interest, or security. Private company security buy/sell agreements often use this three-analyst process. And, disputing parties in shareholder oppression, dissenting shareholder appraisal rights, and other breach of fiduciary duty controversies often turn to the three-analyst valuation process in order to resolve their differences. How the three-analyst process works in each situation is determined by either the shareholder (or other) contract or the agreement of the parties. This discussion recommends guidelines both to valuation analysts—and to other process participants—involved in a three-analyst business/security valuation process.

Introduction

In many closely held businesses, the owners want to personally know all of the other shareholders.[1] For the closely held company shares to transfer in an orderly fashion, the owners may insist that all owners subscribe to an ownership agreement, such as a shareholder agreement.

Such an agreement may have a redemption clause which allows for share purchases to be made only by the company or by the other current owners—and only at the price derived from a contractual valuation process.

The valuation provisions in shareholder agreements typically provide for shareholder liquidity by providing:

1. a market for the shares and
2. a mechanism for the purchase of and payment for the shares.

The current shareholders may want to know that the shares will stay in friendly hands in the event of another shareholder's termination of employment, retirement, physical or mental disability, or death.

The shareholder agreement will also typically address the ownership of the shares in case of involuntary transfers due to another shareholder's divorce, bankruptcy, insolvency, or legal disability.

The valuation process can include various adjustments to account for particular attributes or circumstances that the individual shareholders face. For example, the individual shareholder usually does not have the unilateral right to influence or control the management and operations of the subject company.

Therefore, the valuation process can include various adjustments to account for an individual shareholder's lack of ownership control.

Sometimes the prescribed valuation process requires the application of a valuation pricing formula.

To be respected by interested parties (including, for example, the Internal Revenue Service), the valuation pricing formula should be clear, unambiguous, and bear some resemblance to the fair market value of the shares particularly at the time the valuation pricing formula is established.

It may also be important that the valuation pricing formula result in the fair market value of the

shares as of time of the event (occurring sometime in the future) that triggers the application of the formula.

Disadvantages of Relying on a Valuation Pricing Formula

It is unusual for any one formula that was selected at one point in time to consistently provide reasonable and realistic valuations at all other points in time. Dislocations can occur.

Typically, a formula is not very flexible. After all, it's supposed to be "fixed" and unambiguous. A formula may not be flexible enough to take into account changes in, for example, the following factors:

1. The company's prospects
2. Industry in which the company operates
3. Current economic environment
4. Prevailing accounting conventions

If the triggering event occurs when the company is affected by a temporary upturn or downturn, the valuation pricing formula could be viewed to be unfair.

Businesses change due to nonrecurring events such as the introduction of a new product line. Before the introduction of a new product, reported earnings may be abnormally low because they reflect one-time research and development expenses to create the new product and marketing expenses associated with the launch.

After the new product is successfully launched, the early positive earnings may be low. This is because they do not yet reflect the normal, longer-term expected earning power of the new product.

Conversely, the currently reported earnings of the business could be higher than they are expected to be in the future because demand for a significant product has declined or because of a delay in the performance of a significant customer contract.

Industries change when, for example, regulatory restrictions are temporarily added or eliminated. Competitors can make impulsive decisions that have only a short-term impact on the earnings or assets of the subject business.

It is not unusual for a valuation pricing formula to fix the multiple of earnings or the multiple of book value despite any changes in the external economic environment. The economic environment in which the company operates is always changing both locally and nationally.

Events that affect the economic environment that are entirely external to the business can have an important impact on the value of a business. The effect of those external events may not be captured in the typical valuation formula.

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Net asset value (or net book value) isn't supposed to be controversial but it often is. Accounting rules can change or the business may adopt an alternative but acceptable accounting convention after the valuation formula was established. This procedure could cause a dislocation to the share value under the valuation formula.

For example, the company may voluntarily or involuntarily change its policy regarding contract revenue recognition, last-in, first-out (LIFO) or first-in, first-out (FIFO) inventory valuation, capital investment capitalization, or categorization of leases as operating or capital.

All parties may not always accept a value derived from a formula (e.g., the Internal Revenue Service may not be required to accept it if it is judged to be a testamentary device). If a transaction takes place for any purpose at a price different from the formula, the integrity of the formula may be jeopardized.

Earnings of the business may be volatile. Some formulas try to accommodate for that volatility by, for instance, using a strait average or a weighted average of the trailing three years of earnings.

In some situations, the formula valuation calculation is made only once per year as of a specific date and the price is supposed to prevail until a new value is calculated the following year. In other situations, the formula valuation calculation is made quarterly or even daily.

The company may not have enough money on hand to be available to redeem the shares at the formula price. The company (or another shareholder, for instance) who has the opportunity or the obligation to redeem the shares may not have the cash available (or the proceeds from a life insurance policy) to satisfy the obligation.

To overcome these disadvantages, rather than relying on a valuation pricing formula, many

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shareholder agreements call for a valuation pricing process.

The Valuation Pricing Process

A common valuation pricing process requires the company to establish a price at which it intends to redeem the subject shares. That price may be the result of the application of a valuation pricing formula.

If the shareholder rejects the company's offer price, it is common for the next step in the valuation process to require that each of the parties retain its own valuation analyst.

The valuation process should outline each analyst's assignment. There are several possible assignments, as follows:

1. Each analyst reaches an independent opinion of value and issues an opinion report to his or her client. If the two values are close, say within 10 percent of one another, the average value is the price at which the redemption transaction takes place.
2. The two analysts work together to reach one opinion of value which establishes the transaction price.
3. Without rendering an opinion of value, the two analysts agree on a third analyst to conduct one independent opinion which establishes the transaction price.
4. After rendering opinions that are too far apart (say, beyond 10 percent), the two analysts agree on the name of a third analyst.

The Valuation Target

When the two parties expect the decision maker (the judge) to split the opinions of each of the two parties or weight them somehow, it is more likely that the parties will adopt extreme positions and encourage their analyst to follow their valuation target. We often see that in marital dissolution cases, for example.

However, if the two parties anticipate that the judge will not split the difference but instead will choose only one of the two valuations, then each party will be more likely to encourage a less extreme valuation target. This is the theory behind what is known as baseball arbitration.

But, baseball arbitration only creates the right set of incentives for the parties when both parties would always be better off by submitting a more honest, less biased valuation than a more aggressive one.

Baseball arbitration works well in situations when, after the negotiation, the two parties will continue to have a relationship with each other (as in a labor dispute or when the parties are slicing a whole pie) because the downside of taking an aggressive position that is found to be unsuccessful by one of the parties is great.

Even if an aggressive position was found to be successful, in a marital dissolution for example, the subsequent grudge will impute a cost on the future relationship between the two parties.

Using the marital dissolution situation as an example, the parties are dividing one pie (the collection of marital assets), but they may share responsibility for raising their children, and the cost of causing greater deterioration of the future relationship could be great.

Baseball arbitration may not work well in situations where:

- a party believes that the decision maker is likely to make an error;
- one of the parties can achieve an outsized positive result without the same risk of a downside result (due to having a relatively small ownership percentage or some other kind of financial leverage, for instance); or
- there is no expectation of an ongoing relationship between the parties.

When one or both of the parties is encouraged to take an aggressive position, a third analyst is often required to effectuate a transaction that has been triggered by the provisions of a buy-sell agreement.

The third analyst's assignment is to:

1. select one of the party's opinion or the other (baseball arbitration);
2. develop his or her own independent opinion, which will prevail; or
3. develop his or her own independent opinion, which is averaged with the closer of the

other two opinions of value—this penalizes the outlier valuation target.

The Third Analyst's Assignment

Most shareholder agreements do not completely describe the third analyst's assignment so the components of the third analyst's assignment should be carefully defined, regardless of the written shareholder agreement.

The most obvious reasons for clearly defining the assignment is for all parties to know who is responsible for providing the following:

- Professional services to execute the assignment and to whom that person reports
- Information that is required to execute the engagement and with whom that information may be shared
- Payment for the services and the indemnification of the third analyst.

The third analyst may be engaged to execute any one of several different roles.

In the role of finder of fact, the third analyst reaches a value conclusion based on the evidence provided by the valuation presented by each of the two parties as would a judge.

As mediator, the third analyst's role is to reconcile the opinions of others and to assist the parties is reaching an agreement. The mediator educates the parties and offers options that may resolve the differences.

When the third analyst is engaged to render an independent opinion, the third analyst should make sure the parties are aware of the third analyst's instructions so that the parties to the valuation pricing process will respect the results.

Instructions for the third Analyst

Many people hold the mistaken notion that there can be only one "value." Instead, those familiar with the valuation profession are aware that there are many factors that influence the value conclusion.

The first influential factor is the applicable definition of value. The purpose of the valuation usually determines the appropriate definition of value.

Identifying and clearly defining the purpose and objective of the business valuation assignment goes a long way towards eliminating many of the problems that occur with the conclusions of business valuation projects.

While it seems simple, and should be simple to understand, failure to clearly define the elements of the valuation assignment at the outset of the business valuation assignment is one of the greatest sources of errors, delays, excess costs, and misunderstandings between client and analyst in a business valuation.

It may seem obvious that the first step is to define the task. However, when asked to participate in finding a solution to a client's problem, the client often does not know how to define the valuation assignment, and communication to agree on and mutually understand the assignment is often an important step.

In fact, valuation assignments that have turned out poorly are often due to a failure to carefully define the assignment at the outset.

The components of a well-defined third analyst (or almost any other business valuation) assignment include the following:

- Objective
- Purpose
- Property subject to value
- Definition and premise of value (contract, state law)
- Applicability of discrete valuation discounts, including key person dependence
- Valuation date
- Valuation approaches and methods
- Work product

In a third analyst process, the objective of the valuation assignment should be made clear and in writing. The typical objective for the third analyst is to provide his or her professional opinion of the value of the shares that are subject to redemption as of the valuation date.

The shares subject to redemption usually represent a noncontrolling, nonmarketable equity interest that is to be redeemed under the terms of the buy-sell agreement.

It is not always appropriate, however, for the third analyst to apply discounts from the pro rata value of the shares to reflect the shareholder's lack of control and lack of marketability.

Different statutory, regulatory, and case precedent standards govern valuations of businesses and business interests under various jurisdictions for diverse purposes. Many business valuations fail to reach a number representing the appropriate definition of value because the analyst failed to match the valuation methods to the purpose for which the assignment was being performed.

The result of a particular valuation can also be inappropriate if the client attempts to use the valuation conclusion for some purpose other than the intended one.

Valuation reports typically contain a set of limiting conditions and one of the typical limiting conditions is as follows:

> This valuation is valid only for the valuation date or dates specified herein and only for the valuation purpose or purposes specified herein. No other purpose is intended or should be inferred.

Much of the litigation involving business valuation arises because the parties have failed to match the valuation methods to the assignment's intended purpose.

The purpose of the valuation encompasses the use to which the valuation exercise is expected to be put. A valuation conclusion prepared for one purpose may not be the appropriate valuation conclusion for another purpose.

The purpose of the valuation often determines the applicable standard of value—that is, the definition of value being sought—and almost always influences it.

The date, or dates, at which the business is being valued is critically important because circumstances can cause values to vary materially from one date to another, and the valuation date directly influences data available for the valuation.

Every day, observers of the public stock markets see sudden and substantial changes in the value of a particular company's stock.

In many court cases, especially those involving tax litigation, significant changes in value over very short time spans have been justified because of changes in relevant circumstances.[2]

Many internal and external factors can cause changes in the value of an interest in a company. Obviously, a sudden change in a company's earnings, especially if unanticipated, can have a substantial effect on value.

Also, the value of a business interest varies with the cost of capital, a factor over which individual businesses have little control. Major events, such as the signing or termination of a major customer contract, can also have a dramatic, immediate impact on value.

In most business valuations, the opinion of value will be based at least partly on other, similar transactions, such as the prices at which stocks in the same or a related industry are trading in the public market relative to their earnings, assets, dividends, or other relevant variables, if such data are available.

It is important to know the valuation date when using guideline companies in the valuation so that the guideline transaction data can be compiled as of the valuation date, or as near to it as is practically possible.

The valuation date is usually the date of the event that triggered the provisions of the buy-sell agreement which is often the date on which the shareholder's employment was terminated.

But there are other events that may have triggered the redemption of the subject equity investment such as oppression of the shareholder or dissent by the shareholder from actions taken by the company management.

Sometimes there is more than one valuation date. For example, in shareholder redemptions, the parties may not stipulate to the trigger date and the value as of more than one date many be needed in order to resolve the dispute.

When the choice of valuation date in such cases is a legal matter, as part of defining the assignment, the third analyst may be asked to consider all the potentially applicable valuation dates and be prepared to address the value as of each date.

Sometimes a court will give an advance ruling on the valuation date to avoid the expense of doing analyses as of dates that the court will not deem relevant.

Some of the most important sources of guidance as to the applicable standard and premises of value for the given situation are the following:

- Statutory law (state and federal)
- Case law (cases decided under the controlling statutory or common law)
- Administrative regulations (e.g., Internal Revenue Service revenue rulings)[3]
- Company documents (e.g., articles of incorporation or partnership, bylaws, meeting minutes, agreements)
- Contracts between the parties (e.g., buy-sell agreements, arbitration agreements)
- Precedent established by prior transactions
- Directives issued by the court (in some litigated cases where the standards or premises are not clear, the analyst may take the initiative to seek direction from the court regarding the relevant definition of value)
- Discussions with an attorney involved in the valuation matter or experienced in similar matters
- Legal case documents (e.g., complaint, response, and so forth)
- The analyst's experience and judgment

In certain situations, the third analyst's assignment may be limited to analyzing only a certain valuation method or only one component of the dispute between the parties.

For instance, the controversial matter that separates the parties may be the proper normalization adjustments to make when arriving at a component of the valuation pricing formula such as EBITDA[4] or book value.

It is also important that the form of the third analyst's work product be understood. The form of the work product ranges from an oral opinion of value to a simple letter to a full narrative opinion report including all supporting data and documentation.

Communication

For the valuation process to be respected, it's important for the third analyst's instructions regarding communication be understood.

The third analyst should be instructed regarding the confidentiality of the documents being produced, whether the parties will be producing documents separately, whether documents produced by one party are to be shared with the other party, whether either party is permitted to communicate orally or by electronic means with the third analyst outside of the presence of the other party, how will any required in-person site visits be attended, and the dissemination of the third analyst's work product.

Unlike the delivery of work product in the typical valuation assignment, in the case of the third analyst valuation process, the work product is usually not issued as an incomplete document that is subject to discussion.

The benefit of issuing incomplete work product for discussion purposes in the typical valuation assignment is to allow the audience to provide advice regarding the accuracy of the information upon which the analysis depends and to achieve a reasonable understanding of the analysis.

Instead, the work product of the third analyst is a complete, final opinion that is not subject to discussion.

There is no universally acceptable final work product format for the third analyst. The work product may be a full narrative opinion report prepared in a format consistent with that proscribed under (1) the Uniform Standards for Professional Appraisal Practice or (2) another set of agreed-upon business valuations standards.

The work product may be nothing more than a simple statement of conclusions. Or, the work product could follow any other format to which the client agrees.

The third analyst is entitled to indemnification. A typical indemnification provision states that the parties agree to indemnify and hold the third analyst harmless from, and will defend the third analyst

against costs or liabilities of any nature whatsoever which result from, claims against the third analyst where such claims arise out of any use of the results of the third analyst's work on this engagement.

The third analyst will provide independent valuation assistance only. The third analyst will not provide legal, accounting, or taxation advice.

The parties may want to develop some reasonable expectations regarding the timetable for the start and completion of the project and any important intermediate events.

Who will be responsible for paying the third analyst's fees and expenses should be clear. It is usually a good practice to reach an understanding and to establish reasonable expectations regarding the amount of the fees and expenses that will be incurred in performing the assignment as defined.

Typically there is no work required from the third analyst after rendering the final opinion. Therefore, the third analyst should expect to be paid before rendering that opinion.

Conclusion

The third analyst assignment may seem to be simple, but it is important for the parties who are engaging the third analyst to recognize the following:

1. The parties who are engaging the third analyst are already involved in a controversy.
2. Valuation problems are inherently controversial.
3. Value conclusions are usually not based on absolutely settled data and professional judgment is a prerequisite to solving the valuation problem.
4. The third analyst is taking directions and is not the director of the project.
5. Clients don't want the third analyst's fees to include a premium to account for the risk of valuation malpractice litigation.
6. For the indemnified third analyst, the scope of the valuation assignment can be narrowly focused on the controversial valuation issues.
7. For the unindemnified third analyst, the scope of the valuation assignment includes the time required to continuously challenge the integrity of the instructions given to other professionals, instructions given by other professionals, advice rendered by other professionals, and information provided by the client and other professionals.

   Analysts should refuse to accept third analyst assignments unless the parties provide adequate indemnification.
8. For the parties, the possibility that valuation malpractice may be alleged is disruptive to the entire professional team.
9. For both the plaintiff and the defendant in litigation alleging valuation malpractice, it is complicated, expensive, and there is a low probability of a satisfactory award.

Of course, parties to the third analyst valuation process do not want to be involved in subsequent litigation and neither does the third analyst. When the assignment is to provide the best, unbiased opinion, the third analyst should be indemnified from future litigation. The analyst doesn't control many of the circumstances that surround the resolution to the valuation controversy.

When both parties to the third analyst assignment provide indemnification, it does not mean that:

1. the third analyst is not independent,
2. the strength of the third analyst's opinion is weakened,
3. the third analyst's opinion is tainted, or
4. the third analyst will not stand behind and defend the opinion.

Notes:

1. For convenience only, "shares" is used in this discussion to refer to the equity that is subject to a legal agreement to which the equity owners are committed. The equity may be shares in a corporation or units in a partnership or units limited liability company.
2. See, for example, Morris M. Messing, 48 T.C. 502 (1967), *acq*. 1968-1 C.B. 2. Even though the company made a public offering at over $36 shortly after a gift of stock, the court upheld a value of $13 for gift tax purposes as of the date of the gift.
3. Note that administrative rulings do not have the force of law, but represent the position of the agency administering the law as to their interpretation of the law and rules for applying it.
4. Earnings before interest, taxes, depreciation, and amortization.

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